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TAGS: EPET ENRG ECON PREL RS
SUBJECT: RUSSIAN ENERGY: PSAS -- THE VIEW FROM SAKHALIN AND MOSCOW

Classified By: Amb. William J. Burns. Reasons 1.4 (b/d).

¶1. (C) Summary. From discussions in Moscow and Sakhalin this week, Production Sharing Agreements (PSAs) may be out of favor, but they are far from being driven out of business. Shell (Sakhalin-2) appears to have dodged the bullet of having its environmental license revoked, but still faces tough negotiations with Gazprom and the GOR on asset swaps and cost overruns, respectively. ExxonMobil (Sakhalin-1) is getting splashed by the mudslinging surrounding Shell, but to almost no effect; the first tanker loading from the De-Kastri port is expected to go forward October 5. Putin and many of Russia's elite seem to resent the PSAs as unwelcome reminders of a weak moment in Russia's past, but the emerging line for both supporters and opponents of PSAs is one of strict adherence, for all sides. In practice, that means the GOR will not try to annul existing PSAs, but PSA holders are being clearly warned to strictly abide by the terms of their agreements and Russian regulatory processes. The alternative is unhappy since any move to annul one of the three existing PSAs would certainly end up in Stockholm arbitration. End Summary.

¶2. (C) This note reflects on a number of meetings the week of September 25, including the Ambassador's September 27 meeting with the head of the ExxonMobil's (EM) Moscow office, Ben Haynes, and additional meetings between Econ M/C and officials and company representatives on Sakhalin Island.
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Sentiment Towards PSAs Souring But Revocation Not An Option
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¶3. (C) The upbeat mood in the Sakhalin Governor's office this week was in stark contrast to the harsh rhetoric swirling around the issue of PSAs in Russia's capital. The sour mood in Moscow reflects an emerging, but deeply held view by Putin and the key officials around him: the three PSAs signed in the mid-1990s were good for Russia then, but are "sub-optimal" by today's boomtown standards. Yet, while some may dream of extracting better conditions from their PSA partners by whatever means they can, it seems clear from our conversations this week that there is no appetite in Sakhalin to see existing PSAs overturned.

¶4. (C) In a September 25 meeting, Sakhalin Governor Ivan Malakhov was explicit on this point, at times implying he was

not sure what his colleagues in Moscow thought they were doing. He categorically opposes canceling existing PSAs, but he also expects rights holders to comply fully with their obligations under Russian law and the terms of their contracts. Malakhov's position makes sense: his oblast has begun to see a significant revenue stream since first oil at Sakhalin-1 a year ago ($50 million so far), and there is more to come once tanker loadings begin from the De-Kastri terminal next week and export volumes rise to 250,000 barrels per day (b/d). The biggest threats to future money flows from this project to the oblast are regulatory setbacks, and thus his expectation that the PSAs on the island are run well, and regulatory issues be dealt with promptly.

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Sakhalin 1 and 2 Perceived Differently

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¶5. (C) Malakhov sees significant differences between the management of the Sakhalin 1 and 2 projects. He praised EM (the operator of Sakhalin 1) as "flexible" and "responsive," dealing with issues expeditiously, and maintaining a solid dialogue with local authorities. About the management of Sakhalin 2, Malakhov was less complimentary, criticizing Shell for letting issues "pile up" and complaining that the firms' local representation seems two-headed, by which he meant both uncoordinated and lacking HQ-connected leadership. Malakhov refused to be drawn out on whether he thought Minister of Natural Resources Trutnev and other federal authorities were acting "aggressively" with respect to PSAs or Sakhalin 1 in particular, but he didn't leave the topic without restating his conviction that while existing PSAs should not be cancelled, neither should poor management practices be tolerated.

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The View Of/From Shell

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¶6. (C) From discussions this week in Sakhalin, it appears that Sakhalin 2 has had its share of problems, including reportedly 18 job-related deaths, which one insider said was a sure sign that there were other problems beneath the surface: safety is usually the top priority in multinational projects. It may be that Sakhalin 2 management, because of the magnitude and tight timetable of the project has had a hard time keeping on top of its numerous sub-contractors (there are some 17,000 employees right now). It was a subcontractor (now fired) that was responsible for the August RosPrirodNadzor (RPN) negative inspection finding that appears to have "triggered" the near-revocation of Sakhalin 2's 2003 State Environmental Expert Review (SEER) certification. Sakhalin Energy (the Shell subsidiary running the project) may also not be aware that its relationship with local authorities is slipping -- "local government is very supportive" top management told us confidently, only days after the local government (who otherwise has nothing bad to say about PSAs) had been upset enough about Sakhalin Energy to complain openly to a foreigner about the firm's behavior.

¶7. (C) That said, it is unlikely that Sakhalin Energy has so badly botched the job as to deserve the kind of reputational pressure they have been put under this month. Project Director, David Greer, told us September 27 that Sakhalin 2 has been subject to over 5,000 inspections over the past year. The current problems with RPN, he believes, stem from a summer trip to Sakhalin 2's nearly-completed LNG terminal by DPM Dmitry Medvedev. According to Greer, after having seen how close Sakhalin 2 was to starting LNG exports (expected in 2008) Medvedev pushed to get the Gazprom-Shell asset swap that has been on hold for a year moving again. Like many analysts in Moscow, Greer believes the actions of RPN are just noise intended to soften up Sakhalin 2 shareholders, driving down the perceived value of Sakhalin 2 in advance of their September 29 meeting with Gazprom.

¶8. (C) According to the British Embassy, Dutch PM Balkenende reached out to Putin by phone this week to protest rumors that Sakhalin 2's 2003 SEER had been revoked. Putin is reported to have called the PSAs "colonial era agreements" while agreeing to pull back the threat to the SEER. Putin made a point, according to our British colleague, of urging PSA management companies to be diligent in their adherence to their obligations under Russian law.
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And The View From ExxonMobil

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¶9. (C) Exxon Neftegaz (EM's Russian arm) Executive VP Jim Taylor related to us this week that a grudging sense of unfairness seems to be what motivates watchdog agencies like RosTekNadzor (RTN -- which some compare to OSHA) and RPN (an agency within the Ministry of Natural Resources (MNR) responsible for environmental issues in the energy sector) to plow through piles of documents and examine endless miles of pipe and facilities in search of fault. EM was investigated some 60 times this year alone. Taylor said that Exxon Neftegaz has been quick to address concerns raised in the inspection process, preferring to keep Sakhalin 1 moving forward rather than argue with the regulators.

¶10. (C) As an example, Taylor cited environmental issues raised by RPN about the De-Kastri port, where tanker loadings are expected to start on time October 5. The inspection resulted, among other things, in the firm's extraordinary paving over of a sewage basin -- a requirement not found in Russian law, but raised by the inspectors. The announcement last week of a relatively minor set of environmental issues surrounding De-Kastri (including the already resolved issue of the paved sewer basin) surprised Taylor somewhat. He speculated that the inspector may have come under pressure to say something publicly about Sakhalin 1 on the day Shell's SEER appeared pulled -- even though the two events were not comparable. Likewise, Haynes told the Ambassador that the press had greatly exaggerated the concerns over the De-Kastri oil terminal. He said RTN had, in fact, given the project "rave reviews" for its environmental compliance. Haynes did note with concern, though, that RTN head Pulikovskiy made "sharp" public comments about both Sakhalin projects

subsequent to this.
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With Time, GOR likely to Expand
Scope of Chayvo Field

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¶11. (C) Exxon Neftegaz President Stephen Terni expressed confidence in a meeting September 27, that the Chayvo field problem, whereby a portion of the oil field was inadvertently left outside the original PSA are, will eventually be solved. Terni and Taylor maintain that granting Sakhalin 1 rights to the parcel is just good field management practice for any government, and that such a contingency was foreseen and covered in their 1996 PSA. Rosneft VP Peter O'Brien (Rosneft is one of Exxon's partners in the project) agrees, and both sides confirm that Rosneft and EM have formed a united front against the Ministry of Natural Resources. The heat behind this issue -- which in many places around the world would be considered routine -- appears tied (again) to general pique surrounding PSAs. One of Malakhov's assistants told us after the meeting with the Governor that this is a clear case of the government not wanting to give the firm another chunk of reserves at "1996 PSA price...no more cheap deals for foreigners."

¶12. (C) Taylor believes that with time, the obvious mistakes made by MNR in this case will fade in the collective memory, allowing the project to move forward quietly. Taylor noted that MNR had already ruled once in the firm's favor on this, and thought they would do so again. Rosneft's O'Brien shares Taylor's confidence that the situation is already on its way

to resolution, and while he would not go so far as to exclude the possibility of the parcel coming (back) into the consortium via auction, he doubted that outcome very much.

¶13. (C) Haynes was, perhaps, a little less sanguine on Chayvo during his meeting with the Ambassador. Despite rebuffing a suggestion at a recent meeting with MNR that re-opening the PSA would help "resolve" the Chayvo issue, Haynes said that he felt the Ministry was willing to work constructively with EM. Nevertheless, Haynes said that some in EM are "very close" to employing a dispute resolution mechanism included in the PSA that would require taking the case to Stockholm. He recognized, however, that such a move would be quickly picked up by the press and may be unhelpful for some of their other equities in Russia.
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Cost Overruns?
Sakhalin 1 - A Little
Sakhalin 2 - Yes

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¶14. (C) Last week, a story surfaced in the press that EM faces significant cost overruns at Sakhalin 1. Haynes said that these reports were generally inaccurate, maintaining that the 2001 development plan foresaw spending of $12.1 billion in constant 2002 dollars. Factoring in foreign exchange fluctuations since then, he said the consortium is within ten percent of their per-barrel spending estimates. Haynes maintained that this was an "extraordinary" result for a project of such magnitude. According to Taylor on Sakhalin, the discussion in any event is purely theoretical at this point, as EM gas only spent $6 billion, and it will take until 2012 (when the bulk of the project should be up and running) to determine if the cost estimate was correct. It was not clear to Taylor why this old bit of news was surfacing now.

¶15. (C) The situation with Sakhalin 2 is different. Sakhalin 2 is near the end of phase II of a two-phase project, and the cost overruns they cited a year ago in August were based on actual, not projected, overruns. Sakhalin Energy agreed with the GOR on a $9.6 billion price tag for the project in May ¶2003. In the meantime, explains Greer, approvals took longer, steel prices rose, and contractor costs ballooned -- all of which put huge pressure on the budget. By early 2004, it was already clear that costs would exceed $13 billion, and that estimate rose by early 2005 to almost $20 billion. The public announcement of the cost overruns in August 2005 (right after the Gazprom-Shell asset swap MOU was announced) was driven by public disclosure requirements associated with Shell acquisitions elsewhere in the world. Since Sakhalin 2

is a full-cost recovery PSA (unlike Sakhalin 1 which is on an 85 percent cost recovery basis and therefore is paying out some to the GOR) the overruns will delay the GOR's expected pay out date.
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Comment

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¶16. (C) It appears that EM's Sakhalin 1 project is much less exposed to GOR pressure tactics than is Shell's Sakhalin 2 venture. Moreover, the latest interest in the PSAs (including Total's Kharyaga project) is likely driven by a host of factors: the perceived unfairness by the Russians of the PSAs' terms, Gazprom's drive to get into these projects, intra-governmental rivalries, and the fact that foreign companies have majority control of significant energy projects at a time when this sort of deal structure is out of favor with the GOR. Despite all of this, according to the people we have spoken to, this renewed attention will most likely stop well short of PSA revocation. We are consistently hearing from EM and Shell, and for now we agree, that the best short-term course of action is to ride out the current tempest calmly, with little public comment, while

continuing privately to let the GOR know we are watching. A more aggressive strategy would be warranted if things take a turn for the worse in coming weeks, such as over EM's "dispute resolution" situation or over Shell's upcoming SEER court cases that will unfold in coming weeks that could throw Sakhalin 2 into crisis and embolden the Russian authorities.
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